

THE PRIVATE PLACEMENT EXEMPTION: STATE LAW DEVICES FOR RESTRICTING TRANSFER IN THE CONTEXT OF FEDERAL SECURITIES LAW

I. INTRODUCTION

Adoption of Rule 144 and other recent expressions¹ of Securities and Exchange Commission² policy on the "private placement" exemptions from registration under the Securities Act of 1933³ again emphasize the importance of restrictions on transfer of securities through the specific means of legended certificates, "stop-transfer" orders and letters of investment intent. These three restricting devices in turn are given effect not through the body of federal securities law but rather through states' law, primarily Article 8 of the Uniform Commercial Code.⁴ It appears to have been concluded generally that the three restricting devices provide either nearly complete or the only available insurance against issuer liability arising from secondary distribution of unregistered securities. The conclusion in either alternative is not invalid per se but the underlying analyses are worthy of more careful attention than has been given them in the literature to date. Moreover, some evidence suggests that in practice the use of the three restricting devices is not always complete and automatic. The Commission's current position and the courts' extensions of liability under the anti-fraud provisions of the Securities Act and the Securities Exchange Act of 1934⁵ dictate the conclusion that omission from the private placement game plan of the three devices may have increasingly serious consequences.

This discussion will examine the legal effect of the three transfer restricting devices under federal securities law and the Uniform Commercial Code and will give special attention to potential liabilities of the issuer, the transfer agent and their attorneys. Of necessity, the discussion will probe and highlight the interrelation and lack thereof between the two bodies of federal and states' laws. In the broadest terms, the three restricting devices are used to avoid registration under the Securities Act; the aim is accomplished by making secondary distributions both undesirable and difficult if not impossible. Because Article 8 of the Code is intended to confer negotiability on investment securities, transfer restrictions run counter to its most basic purpose, and indeed conflict with a more pervasive history of legal thought eschewing limitations on alienation of property. These conflicts between the objectives of unlimited

¹ SEC Securities Act Release No. 5223 (Jan. 11, 1972) (Rule 144). Also material to this discussion is Proposed Rule 146, SEC Securities Act Release No. 5336 (Nov. 28, 1972), and to a lesser extent Proposed Rule 147, SEC Securities Act Release No. 5349 (Jan. 8, 1973).

² Hereinafter referred to as the Commission.

³ Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as Securities Act.]

⁴ UNIFORM COMMERCIAL CODE (1962 Official Text) [hereinafter cited as U.C.C.].

⁵ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1970) [hereinafter cited as Exchange Act].

transferability of securities and protection of the investing public on one hand and between two bodies of law separately drafted for different purposes on the other provide the context within which the issuer planning a private placement must chart its course. Because the three transfer restricting devices are used primarily to avoid liabilities under federal law, it is appropriate to consider first the issuer's problem in the context of the Securities Act.

II. THE ISSUER'S DILEMMA: THE RISK OF A PUBLIC OFFERING

A. *The Commercial Context and the Risk of a Public Offering*

One commentator has observed that over one third of all corporate financing in the United States since 1945 has been privately placed.⁶ While most of the investors have been institutions,⁷ the relatively unsophisticated private investor still plays a substantial role in corporate financing.⁸ Although the difficulties of statutory interpretation raised in this discussion are found in many contexts,⁹ they are particularly troublesome to the new and small but growing company.¹⁰ As expansion opportunities raise the need for additional venture capital, management may not be enthusiastic about the problems attendant to "going public," or even of the reports required under the provisions of Regulation A.¹¹ After exploring the possibilities of private placement with institutional investors, management may be unwilling to meet the terms demanded by those investors¹² and feel that it can sell its securities to private investors at a more favorable percentage of market value. Accordingly, management may carefully select 15 to 20 offerees,¹³ whom it will make pretense

⁶ W. CARY, CORPORATIONS 1339 (4th ed. unabr. 1969) (citing SEC Statistical Bull., Apr. 1968).

⁷ Approximately 90 percent have been insurance companies. *Id.*

⁸ At least one indication of the continued vitality of the private placement exemption is provided by recent promulgation of SEC Rule 144 and the continued reluctance of the Commission to take the ultimate step of flatly requiring use of the three transfer restriction devices for Securities Act § 4(2) qualification. See section III, *infra*.

⁹ For example, the problems of disposal of privately placed securities are raised by both the risk of public offering discussed herein and the "control" concept under the Security Act definition of an underwriter. See Securities Act § 2(11), SEC Rule 144; A. Sommer, *Who's in Control?*, 21 BUS. LAW. 559 (1966), in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 195 (ABA 1968).

¹⁰ And even more so if the company has so few shareholders that there is no established over the counter market for its shares, and assuming no reporting requirement under § 12(g) of the Exchange Act.

¹¹ Under Securities Act § 3(b). Moreover, management may intend to exceed the \$500,000 limitation.

¹² Management may well be concerned in this situation about retaining control inconsistent with the terms demanded by both some institutional and very sophisticated private investors or about agreeing, for example, to maintain a given level of working capital.

¹³ Four of whom reside in another state. This hypothetical avoidance of the intrastate exemption, Securities Act § 3(a)(11), should not be taken to minimize the necessity for a thorough

of indoctrinating with all the information registration would provide (even assuming availability of such information). The risk of public offering can arise in several ways. For example, management may learn either before or after transfer that several of its offerees intend to transfer shares to others immediately after receipt,¹⁴ or are acting as nominees for investor groups; after the distribution, management may learn that some of the shares have been pledged to creditors.

Because the Commission lacks the means to police all private placements and perhaps because of general tacit acceptance of a "number of offerees" test, so long as all goes well and the investment attractiveness of the shares increases, the risk of unregistered public offering effects is reduced substantially. When, however, circumstances unique to the issuer or to its industry lead its shareholders to unsuccessful attempts to dispose of their privately placed securities, complaints of unauthorized distribution are more than a remote possibility.¹⁵ As this discussion will demonstrate, the effects of these complaints will differ materially if the issuer has employed legended certificates, letters of investment intent and the stop-transfer order or if the issuer has ignored these devices for restricting transferability of the shares distributed. The latter practice may be commonplace in those market localities where investors are characteristically reluctant to accept legended certificates.

The foregoing observation raises a material practical consideration: While the issuer's counsel may be concerned primarily with avoiding a public offering and the consequences thereof, management's first concern is raising capital. This means, first, that restrictions on the transferability of the privately distributed shares should go only as far as is necessary to provide protection under the Securities and Exchange Acts; further restrictions will necessarily decrease the investment attractiveness of the securities. Second, management's interest in a lucrative distribution invites counsel to ignore risks attendant to private placement. Prior to examination of the increase in potential liability occasioned by omission from a private placement of the three restricting devices, a brief examination of the private distribution in the context of the Securities Act is appropriate.

Section 5(a) of the Securities Act makes unlawful the sale of a secu-

examination of local law in any unregistered offering. With respect to exceptions to state Blue Sky regulation, *see, e.g.*, OHIO REV. CODE ANN. §§ 1707.02, .03, .06 (Page Supp. 1970), and note 38 *supra*.

¹⁴ A possibility some results of which are discussed in an unpublished memorandum by Professor J. Slain of the Ohio State University College of Law.

¹⁵ Because the risk of public offering effects increases as the attractiveness of the shares decreases, the ill-advised issuer may be faced with liabilities under federal securities law at a time when it is beset by other substantial difficulties. So long as the "market" value of the shares increases, the practical risk of public offering is reduced substantially.

rity¹⁶ as to which a registration statement is not in effect, and § 5(c) extends the prohibition to offers.¹⁷ Section 4(2) exempts from § 5 "transactions by an issuer not involving any public offering." Construing the intent of the Securities Act to protect the investing public through full disclosure, the Commission¹⁸ and the courts¹⁹ have determined that the existence of a private offering is a question of fact, turning primarily on whether the offerees have access to substantially the same information which registration would provide—a "sophistication and access of the offerees" test.²⁰

Even assuming, however, that the issuer's immediate offerees have access to the requisite information, the private placement exemption can be lost if these offerees transfer securities to the uninformed. This is the problem of secondary distribution, which may make the distributing offeree an "underwriter," one who purchased from the issuer with a view to distribution²¹ and is a "conduit for a wider distribution."²² Thus, a substantial portion of the issuer's risk of public offering will depend upon the "investment intent" of its offerees as that intent is reflected in their subsequent actions.²³

It follows, from the point of view of avoiding registration, that a complete restriction on transfer would preclude issuer liability. If the original offerees were legally unable to transfer title to their shares absent compliance with the Securities Act, the risk of a public offering would be foreclosed. On the other hand, shares so restricted would be of limited investment attractiveness. This observation raises another serious practical problem in planning the private distribution. The offeree who takes with a view to further distribution (which may relate only to the time of holding) will have substantial difficulty in disposing of his securities.²⁴

¹⁶ Making use of an instrumentality of interstate commerce.

¹⁷ "Sale" and "offer" are defined in Securities Act § 2(3).

¹⁸ See, e.g., SEC Securities Act Release No. 5121 (Dec. 30, 1970); SEC Securities Act Release No. 4552 (Nov. 6, 1962).

¹⁹ See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

²⁰ See WHEN CORPORATIONS GO PUBLIC 16-17 (C. Israels & G. Duff, eds., PLI 1962); S. Owen, *The Private Offering and Intrastate Exemptions under the Securities Act of 1933*, ABA L. NOTES (Jul. 1967), rev. in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 165 (ABA 1968).

²¹ Securities Act § 2(11).

²² SEC Securities Act Release No. 4552 (Nov. 6, 1962).

²³ G. Wood, *The Investment-Intent Dilemma in Secondary Transactions*, 39 N.Y.U.L. REV. 1043 (1964), in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 145 (ABA 1968).

²⁴ As an underwriter under § 2(11), and as subject to SEC Rule 144. The burden of establishing an exemption—in this instance § 4(1) (transactions by any person other than an issuer, underwriter, or dealer)—is on the person seeking it, *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1960), and good faith of the secondary transferee may be a factor in determining its status as an underwriter, *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir.), *cert. denied*, 364 U.S. 819 (1960); J. Sargent, *The Guild Films Case: The Effect of "Good Faith" in Foreclosure Sales of Unregistered Securities Pledged as Collateral*, 46 VA. L. REV. 1573 (1960), in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 245 (ABA 1968).

This dampening effect on the value of privately placed shares, is if anything increased by the application of the recently adopted Commission Rule 144.²⁵

B. *The "Clarity" Provided by Rule 144*

In an apparent search for a rule subject to application on objective criteria, the draftsmen of Rule 144 followed the percent formula approach of Rule 154. While this approach, read with other recent Commission releases,²⁶ may alleviate some of the § 2(11) problems at the time of original issue, Rule 144 so limits the ability of the offerees to unload that the investment attractiveness of privately placed securities is reduced in relation to prior law. For example, under Rule 144 can offerees demand an agreement providing the order and amount in which each will be permitted to leak his shares after a given period?²⁷ If such an agreement is reached does the more objective approach of the Rule disregard "investment intent" or is the fact of the agreement itself evidence of underwriter status? Can each of the offerees leak up to the permitted one percent²⁸ or would such an agreement aggregate the securities held by all?²⁹ Moreover, if the issuer consented to such a "leak agreement," would it be deemed to be aware that its offerees intended to sell in a particular period and thus be engaged in a public offering?³⁰

Although the Commission stated initially that it would not issue no-action letters with respect to Rule 144,³¹ the contents of the substantial number of such letters to date provide some insight into its reading of the Rule. While the Commission will not regard "sales within successive

²⁵ Notice of adoption: SEC Securities Act Release No. 5223 (Jan. 11, 1972), 37 Fed. Reg. 596 (1972) [hereinafter referred to as Rule 144]. This is not to suggest that an offeree must violate Rule 144 in order to cause his issuer to lose the § 4(2) exemption. See note 39 and the discussion accompanying notes 61 to 67 *infra*.

²⁶ See section III, *infra*.

²⁷ In this context with respect to Rule 144 itself. Such an agreement might be desirable also because of the disruptive effects of substantial sales on a small market, effects which, according to the Commission, the Rule seeks to avoid. SEC, Div. of Corp. Fin. Letter of Apr. 13, 1972, CCH FED. SEC. L. REP. ¶ 78,769.

²⁸ Rule 144(e).

²⁹ Rule 144(e)(1), (3), 144(a)(1). "Resale of restricted securities by all persons agreeing to act in concert to effect a distribution of such securities would be aggregated." SEC Securities Act Release No. 5186 (Sept. 10, 1971).

³⁰ Such an arrangement might also present problems under Rule 10b-6, 17 C.F.R. 240.10b-6 (1971).

³¹ SEC Securities Act Release No. 5223 (Jan. 11, 1972). The way taken by Mr. N. O. Gaines may still be the only way. W. Kennedy, *The Case of the Scarlet Letter or the Easy Way Out on "Private Offerings"*, 23 BUS. LAW. 23 (1967), in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 115 (ABA 1968). For example, a college student with a wife and two children who had been paid in securities by his former employer, the issuer's president, was recently referred to the "simplicity" of Rule 144 by the Commission. SEC, Div. of Corp. Fin. Letter of Jul. 6, 1972, CCH FED. L. REP. ¶ 78,892. This "simplicity" has already resulted in an interpretive release in addition to the numerous letters. SEC Securities Act Release No. 5306 (Sept. 26, 1972).

six month periods without more"³² or the "mere" fact that officers and directors of the issuer propose to sell securities³³ to require aggregation³⁴ of such securities for determination of the number which may be sold, where 20 holders of restricted stock agree to a specific limiting schedule of individual sales, those holders are agreeing to act in concert for the purpose of selling securities and their sales will be aggregated under the Commission's reading of the Rule.³⁵ Further, the noncontrolling shareholder who makes use of Rule 144 is bound by it as to future sales of restricted securities of the same issuer,³⁶ and pending an accurate measure of over-the-counter sales, even negligible trading on a national exchange will be used to compute the saleable amount.³⁷

Thus, the small company which desires to conduct a private placement and to avoid a small number of institutional investors may be forced to distribute under a covenant either to register a subsequent issue and exchange the legended shares for clean ones or to become a reporting company.³⁸ But even in the face of Rule 144's rigidity, the public offering concept still exists, and with it the issuer's concern for restricting the ability of the original offerees to foreclose the private placement exemption.³⁹ In the context of restrictions on transferability, there is some

³² SEC, Div. of Corp. Fin. Letter of Jun. 13, 1972, CCH FED. SEC. L. REP. ¶ 78,945.

³³ SEC, Div. of Corp. Fin. Letter of May 1, 1972, CCH FED. SEC. L. REP. ¶ 78,824.

³⁴ Under Rule 144(e)(3)(F).

³⁵ SEC, Div. of Corp. Fin. Letter of Apr. 13, 1972, CCH FED. SEC. L. REP. ¶ 78,763. Similarly, meetings of shareholders for the purpose of arranging "an orderly method" of sale trigger both the aggregation provision and Rule 254(a)(2), 17 C.F.R. § 230.254(a)(2) (1971). SEC, Div. of Corp. Fin. Letter of Apr. 12, 1972, CCH FED. SEC. L. REP. ¶ 78,774. Where the agreement is restrictive only and is made pursuant to participation in a public offering, however, the aggregation provision may be inapplicable. SEC, Div. of Corp. Fin. Letter of Apr. 13, 1972, CCH FED. SEC. L. REP. ¶ 78,769.

³⁶ SEC, Div. of Corp. Fin. Letter of Jul. 6, 1972, CCH FED. SEC. L. REP. ¶ 78,894.

³⁷ In lieu of one percent of the class outstanding under Rule 144(e). SEC, Div. of Corp. Fin. Letters of Jun. 9, Jun. 22, 1972, CCH FED. SEC. L. REP. ¶ 78,859, 78,866, 78,867.

³⁸ The dilemma confronting the issuer who plans a distribution under the intrastate exemption, Securities Act § 3(a)(11), is similar in at least two vital respects: First, actions of the offerees may disqualify the issuer's use of the exemption. Second, the problem of disqualification usually arises in the face of other substantial issuer difficulties. The intrastate exemption and a recommended approach are examined in Comment, *The Intrastate Exemption: Current Law, Local Practice and the Wheat Report*, 31 OHIO ST. L.J. 521 (1970). This intrastate problem is not solved by Proposed Rule 147, because that rule contains an absolute placement test. Rule 147(f). The intrastate issuer is still not interested in precluding certain placements of its securities.

³⁹ To some extent, the effects of Rule 144 on the investment attractiveness of restricted securities will serve in part to accomplish this result, with as yet unknown consequences in the marketplace. For example, the Commission has stated that the Rule is not available to persons who have purchased under a stock option plan registered under Form S-8. SEC, Div. of Corp. Fin. Letter of May 10, 1972, CCH FED. SEC. L. REP. ¶ 78,847. Perhaps more important, the application of the Rule to foreclosing lending institutions is certain to affect indirectly the investment attractiveness of privately placed shares. The Commission has taken the positions that, while a lending institution may use Rule 144 in disposing of collateral if its debtor was no more than the holder of shares, SEC, Div. of Corp. Fin. Letter of May 5, 1972, CCH FED. SEC. L. REP. ¶ 78,828, shares of a pledgor and a pledgee acquired in private transactions are subject to the aggregation provision, SEC, Div. of Corp. Fin. Letter of Mar. 28, 1972, CCH FED. SEC. L. REP. ¶ 78,761, and that a foreclosing bank is a "person for whose account securities are to be sold" and thus must comply with the Rule. SEC, Div. of Corp. Fin. Letter of Jul. 31, 1972, CCH FED. SEC. L. REP. ¶ 78,944. For the purposes of computing the amount of securities which may

evidence that the Commission may be moving away from the position that offeree action alone can lose the private placement exemption.

III. TRANSFER RESTRICTIONS UNDER THE SECURITIES ACT

A. *A Change of Position?*

The Commission releases announcing proposal and adoption of Rule 144⁴⁰ contain a strong statement on the use of legends and stop-transfer instructions: "the use of such devices is strongly suggested by the Commission and will be considered a factor in determining whether in fact there has been a private placement." Accompanied by formal (if belated) recognition that the change of circumstances doctrine is unrelated to the disclosure at which the Securities Act is aimed,⁴¹ the statement may reflect a Commission willingness to acknowledge that the character of a distribution, for purposes of applying the private placement exemption to the issuer, should give emphasis to issuer conduct. The question is the application of the Commissioner's statement beyond the confines of Rule 144.

In 1935 the Commission announced that determinations of public or private distribution would be made on the basis of the number of offerees, the number of units offered, the size of the offering and the manner of the offering.⁴² By 1962 the Commission had departed somewhat from these relatively objective criteria and had emphasized that the existence of a private offering was a question of fact,⁴³ not to be found solely with reference to such "self-serving" statements as letters of investment intent.⁴⁴ In the context of secondary distributions, this position put

be sold under Rule 144(e)(3)(6), however, the Commission appears to have extended the scope of § 4(2):

[A] person need not include securities sold in private transactions which are *effected in a manner similar* to private placements by issuers under § 4(2) of the Securities Act.

SEC, Div. of Corp. Fin. Letter of Aug. 9, 1972, CCH FED. SEC. L. REP. ¶ 79,006 (emphasis added). The import of this letter may well be the subject of some debate.

⁴⁰ SEC Securities Act Release No. 5223 (Jan. 11, 1972); SEC Securities Act Release No. 5186 (Sept. 10, 1971).

⁴¹ *Id.*

⁴² SEC Securities Act Release No. 285 (Jan. 24, 1935). There have been several efforts to secure adoption of "number of offerees" tests, at least in limited circumstances. For example, Proposed Rule 181 nonexclusively exempts an issue to less than 25 offerees as not a public offering when it is solely in connection with acquisition by the issuer of "a bona fide going business." Proposed SEC Rule 181, WHEAT REPORT, *Appendix VI-1* at 27. Whatever the validity and ease of application of a numbers test, adoption of rigid numbers criteria runs counter to the underpinnings of the *Ralston Purina* doctrine. See note 19, *supra*, and the accompanying discussion. Moreover, a test which requires that the number of owners not exceed a given number during a given period still assumes restrictions on transferability. See ALI FED. SECURITIES CODE § 227(b)(1)(13) (Tent. Draft No. 1, 1972). Most important is the absolute limitation on the number of those "who purchase securities of the issuer" (*not* from the issuer) contained in Proposed Rule 146(f).

⁴³ *I.e.*, subject to ad hoc determination.

⁴⁴ SEC Securities Act Release No. 4552 (Nov. 6, 1962).

more emphasis on the original offeree's actions and less emphasis on the issuer's conduct and intent. By 1970, the Commission was moved to announce its renewed interest in legends and stop-transfer instructions:

The Division will regard the presence or absence of an appropriate legend and stop-transfer instructions as a factor in considering whether the circumstances surrounding the offering are consistent with the exemption under Section 4(2) of the Act.⁴⁵

Because the 1970 release repeated that the existence of a public offering is a question of fact and that the crucial test is where the securities come to rest,⁴⁶ it is still the law that legends and investment letters (and stop-transfer instructions) do not without more constitute a private offering.⁴⁷ Moreover, the apparent emphasis of the Commission on the issuer may be little more than recognition of the value of the restriction devices as useful in policing⁴⁸ compliance with the Securities Act. This interpretation is consistent with the Commission's statement released the day before its notice of adoption of Rule 144:

In the opinion of the Commission, [Securities Act § 17 (a), Exchange Act § 10(b)] are violated when an issuer, a person in a control relationship with an issuer, or any other person, in connection with the private placement of securities, fails to inform the purchaser fully as to the circumstances under which he is required to take and hold the securities.⁴⁹

The same release noted that Rule 144 is one of the circumstances of which the purchaser "should" be informed and reiterated its "strong recommendation" for use of legends and stop-transfer instructions.⁵⁰

⁴⁵ SEC Securities Act Release No. 5121 (Dec. 30, 1970).

⁴⁶ *Id.*

⁴⁷ *United States v. Custer Channel Wing Corp.*, 376 F.2d 675, 679 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967). In the context of Rule 144, the Commission has emphasized the issuer's responsibilities in response to the question

whether an issuer, in transferring shares in reliance upon Rule 144, may safely rely on the representations of a shareholder that he is in compliance with the requirements of the rule. The staff is of the opinion that Rule 144 does not alter the basic obligation of an issuer not to participate in, or otherwise foster, an illegal distribution under the 1933 Act. The particular procedures an issuer may wish to adopt in order to insure compliance with the rule are within the discretion of that issuer, and the responsibility for the effectiveness of such procedures lies with it. Accordingly, each individual issuer will have to make its own determination as to what steps are necessary to prevent an illegal distribution under Rule 144.

SEC, Div. of Corp. Fin. Letter of Apr. 14, 1972, CCH FED. SEC. L. REP. ¶ 78,754 (emphasis added).

⁴⁸ SEC Securities Act Release No. 5223 (Jan. 11, 1972). A recent Commission response to a Rule 144 inquiry laid stress on the issuer's responsibility as in the nature of policing action: The burden of policing the utilization of the exemption provided by Section 4(2) of the Securities Act of 1933 and the determination of the specific means by which this is accomplished rests ultimately with the issuer of the securities involved.

SEC, Div. of Corp. Fin. Letter of Apr. 12, 1972, CCH FED. SEC. L. REP. ¶ 78,745.

⁴⁹ SEC Securities Act Release No. 5226, Exchange Act Release No. 9444 (Jan. 10, 1972).

⁵⁰ *Id.* Characteristically, the Commission failed to make complete the statement of its intent. If issuer failure to legend certificates, for example, is important enough to invoke the anti-fraud

B. *Liability under the Anti-Fraud Provisions for Failure to Use Legends and Stop-Transfer Instructions*

Whether the Commission's emphasis on transfer restricting devices is merely a recognition of the policing value of those devices or foretells a change in the emphasis of the private offering criteria, the statement that an issuer who fails to fully inform the purchaser of the "circumstances" violates the anti-fraud provisions is not a statement to be taken lightly. First, the language of the release suggests that the prudent issuer⁵¹ will include in the letter of investment intent a recital of knowledge of the restrictions imposed by Rule 144 (to be distinguished from issuer-imposed restrictions). Even though it is unlikely that the private placement offeree would be prosecuted for violation of the anti-fraud provisions, his resale of unregistered securities under circumstances showing less than full disclosure would certainly justify civil remedies. The veiled threat in the Commission's statement, then, could result in more offeree care in the sale of securities purchased in private placement.

Second, given circumstances suggesting more than sheer ignorance of the law, liability for failure to give notice of restrictions may be consistent with the objectives of the Securities and Exchange Acts and may be a further step toward increasing liability under Rule 10b-5. On one hand, it is true that transfer restrictions are not strictly speaking information on the financial condition of the issuer disclosed by a prospectus.⁵² On the other hand, the restrictions imposed by Rule 144 are certainly as important to many unsophisticated investors as is "financial" information; it does not require a long step to reach the conclusion that failure to disclose is "an act or practice . . . which . . . would operate as a fraud or deceit . . . in connection with the purchase or sale of any security."⁵³ This argument is given additional force with the observation that the prospectus does contain detailed information on the securities offered;⁵⁴ at least as much protection for the investor in private placement would demand disclosure of the restrictions imposed by Rule 144.⁵⁵ In short, it is not difficult to call the transfer restrictions imposed by law a material fact of interest to the investor, and to call the omission or misrepresentation of that

provisions, surely it is important enough for the Commission to require as a matter of presumptive definition of private placement. The Commission may have reached this position in Proposed Rule 146, under which the issuer's requisite knowledge is nonawareness of underwriter status, 146(g)(1), but which provides that "reasonable care *shall* include" legends, stop-transfer orders, and letters of intent, 146(g)(2) (emphasis supplied). Moreover, the absolute numbers standard of Rule 146(f) applies to purchasers, not offerees.

⁵¹ This point raises again the issuer's difficulty in selling his securities at a high percentage of market value.

⁵² Securities Act, Schedules A, B. 15 U.S.C. § 77aa (1970).

⁵³ SEC Rule 10b-5(c), 17 C.F.R. § 240.10b-5(c) (1971). See *Affiliated Ute Citizens of Utah v. United States*, 92 S. Ct. 1456 (1972), and notes 60 and 67 *infra*, for judicial recognition of this conclusion.

⁵⁴ Securities Act Schedule A(9), (10). 15 U.S.C. § 77aa (1970).

⁵⁵ The Commission's broad rule-making power is further support for the position—at least in a practical sense. Securities Act § 19.

fact sufficient to establish a cause of action under the anti-fraud provisions.

Third, the specific infusion of the anti-fraud provisions into the context of restriction devices may have substantial effects on the relationship of the issuer to its underwriter, transfer agent and attorney. For example, where the courts will not enforce an indemnity contract in favor of an underwriter who knows of misleading statements contained in an offering circular⁵⁶ it does not shock the conscience to withhold indemnification from the knowledgeable actor who engages in misleading conduct with respect to lawful transfer restrictions. If a Rule 10b-5 violation is to be written into failure to disclose transfer restrictions imposed by law, more than indemnification contracts may be affected. If an underwriting agreement containing a misleading prospectus is unenforceable as against the underwriter with knowledge of the misleading facts,⁵⁷ the issuer which fails to disclose restrictions on transfer may find itself with an unenforceable contract.

Perhaps the most startling effect of the infusion of the anti-fraud provisions into this context, however, could be in the area of continued redefinition of the role of the issuer's and/or underwriter's attorney. While violation of the liabilities given so much attention after *Escott v. Bar-Chris Construction Co.*⁵⁸ are not directly applicable to the failure to use transfer restricting devices,⁵⁹ the apparent increasing tendency of the courts to view "securities attorneys" as independent contractors and not advocate agents is of vital significance to potential malpractice liability.⁶⁰

⁵⁶ *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969).

⁵⁷ *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir.), *cert. denied*, 344 U.S. 856 (1952).

⁵⁸ 283 F. Supp. 643 (S.D.N.Y. 1968).

⁵⁹ As to false and misleading statements or omissions in a registration statement. Securities Act § 11.

⁶⁰ S. SCHULMAN, RESPONSIBILITIES OF THE ATTORNEY, EMERGING FEDERAL SECURITIES LAW: POTENTIAL LIABILITY 177 (Nordin, ed. 1969); *see also* the *National Student* action which, significantly enough, was brought under the anti-fraud provisions. Wall Street J., Feb. 4, 1972, at 6 (Midwest ed.). Similarly, the transfer agent who "knows or has reason to know that an illegal [under Rule 144] distribution would occur" has the duty to take affirmative action, SEC, Div. of Corp. Fin. Letter of Apr. 12, 1972, CCH FED. SEC. L. REP. ¶ 78,745, as does the transfer agent who makes a market. *Affiliated Ute Citizens of Utah v. United States*, 92 S. Ct. 1456 (1972). While *Affiliated Ute Citizens* may increase transfer agent responsibility under Rule 10-b(5), the Court's opinion could foretell increased potential liability of all professionals, including counsel, who are involved in transfer of securities restricted by the Securities Act or by legend. In pertinent part, *Affiliated Ute Citizens* involved defendants who were market making officer/directors of a bank which was the transfer agent and sole depository for legended certificates distributed to members of the Ute nation. The officers allegedly misrepresented the value of the securities and failed to explain adequately the right of first refusal legended thereon. On the facts of the misrepresentations and the officers' position as market makers and in sole possession of the certificates the Court found liability under Rule 10-b(5) absent proof of actual reliance:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor *might* have considered them

If the Commission's application of the anti-fraud provisions is to be read this far, the attorney who permits his client to ignore the legend and stop-transfer instruction is courting disaster for that client and for himself. Because of investor reluctance to accept legended stock, it is unfortunate that the Commission failed to make the requirement absolute—at the very least such absoluteness would have made easier the task of educating issuers to the law and would have put knowledgeable and not-so-knowledgeable securities counsel on a more equal footing.

Fourth, and finally, the effect of infusion of the anti-fraud provisions into transfer restrictions will depend in part upon what language of those provisions is read into the Securities and Exchange Acts. If, as the language of the release suggests,⁶¹ the Commission views this failure to disclose as a deceptive act or practice under Rule 10b-5(3), presumably the remedy available would be in damages. If, however, such omission were viewed as omission to state a material fact under Rule 10b-5(2), then the anti-fraud provisions of both the Securities⁶² and Exchange Acts⁶³ arguably would be violated.⁶⁴ Moreover, if lack of knowledge (actual or constructive) on the part of the purchaser were proven, rescission rights could be available to all offerees⁶⁵ under § 12(2) of the Securities Act.⁶⁶ The difference in § 12(1) and § 12(2) illustrates the problem in an analogous way. Is omission of notice of restrictions imposed by law, without more, a violation of § 5 of the Securities Act? Logic would not require this because securities validly placed under § 4(2), for example, are not immune from the provisions of Rule 144. However, as a matter of issuer liability—and not of disqualification under § 4(1) through § 2(11)—the conclusion could be the opposite. If, as discussed at the beginning of this section, the recent pronouncements of the Commission reflect a greater emphasis on issuer action as opposed to offeree intent, then failure to take action reasonably expected to prevent distribution to

important in making this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

92 S. Ct. at 1472 (emphasis added). The Court's opinion should be considered carefully by any professional who, as a source of information not possessed by his client, counsels that client to undertake activity identified by the Commission as fraudulent in connection with the sale of a security.

⁶¹ SEC Securities Act Release No. 5226, Exchange Act Release No. 9444 (Jan. 10, 1972).

⁶² Securities Act § 17.

⁶³ Exchange Act § 10.

⁶⁴ A *willful* violation of the rule so construed could result in criminal liability. Securities Act § 24, Exchange Act § 32(a).

⁶⁵ Perhaps as limited to their immediate purchasers, *Demarco v. Edens*, 390 F.2d 836, 841 n.3 (2d Cir. 1968), *citing* 185 F. Supp. 943, 946 (S.D. Cal. 1960), a limitation which would serve to place a sanction on the offeree who through secondary distribution causes the issuer to lose the private placement exemption.

⁶⁶ This distinction could be important with regard to difficulties in proving damages, given that punitive damages are not likely in the foreseeable future. *See Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969).

the uninformed public (*i.e.*, use of legends, stop-transfer instructions and letters of investment intent) could be construed to be a violation of the anti-fraud provisions of the Act, without the finding of a public distribution and a violation of § 5 of the Securities Act, where a public distribution results. Indeed, the infusion of the anti-fraud provisions into the restrictions imposed by Rule 144 would seem to make sense only following this latter conclusion. Unless the failure to give notice of the restrictions absent a public distribution is an independent violation of the anti-fraud provisions, the Commission's release has no teeth, because with a violation of § 5 the whole range of federal remedies is otherwise available.⁶⁷

It is to be hoped that much of the foregoing will be rendered academic by universal application and use of the three restriction devices in private offerings. Indeed, preclusion of the application of the anti-fraud provisions is ridiculously simple. Having considered some possibilities of application of the Commission's recent proclamations on the use of restriction devices both in terms of the point of focus for determination of public distribution vis-à-vis the issuer and in terms of the anti-fraud provisions of the Securities and Exchange Acts, it is now appropriate to consider the effectiveness of the devices in the context of federal securities law. What can the issuer do to insure against potentially staggering liability?

C. *The Effectiveness of Restrictive Legends, Stop-Transfer Instructions and Letters of Investment Intent in the Context of Federal Law*

The following section of this discussion will examine the ability of the issuer to restrict the transferability of securities so completely that its offerees are unable to transfer title. The theory goes that if the issuer, for example, can preclude its offerees from transferring title to the privately placed shares, then no offer is possible and the risk of public distribution is foreclosed.⁶⁸ While the possibility of this solution should be kept in mind from this point on, the immediate section of the discussion is concerned with the effect of the three restriction devices more or less exclusive of problems of ownership under states' law.

Because the use of legends and stop-transfer orders is strongly recom-

⁶⁷ See *Abdelnour v. Coggeshall & Hicks*, CCH FED. SEC. L. REP. ¶ 93,340 (S.D.N.Y. Jan. 14, 1972), recognizing a private right of action under Rule 10b-5 for misrepresentations on marketability of restricted shares. A possible exception to this might be the instance where a violation of the anti-fraud provisions is more easily proved than a public distribution, under the facts of a particular case. One other point is worthy of examination. Use of Release No. 5226 to argue for an emphasis on issuer action, coupled with a strict reading of Rule 144, if carried to a logical extreme could lead to the desirable result of limiting issuer liability to issuer conduct inconsistent with the intent of § 4(2) of the Securities Act. Given issuer compliance with the strong suggestion of the recent releases there is no reason to expand issuer liability for offerees' actions over which it has no control. The force of this point is emphasized by language in Proposed Rule 146 dictating use of the three restrictive devices. See note 50 *supra*.

⁶⁸ See C. ISRAELS, CORPORATE PRACTICE § 16.04 (2d ed. 1969) and section V *infra*.

mended,⁶⁹ because use thereof will be considered as a factor in finding the fact of private distribution⁷⁰ and because failure to advise of restrictions on transfer imposed by law may precipitate anti-fraud provision liability,⁷¹ compliance with the Commission's "strong" recommendation is the only prudent course. Use of the three devices, moreover, should be recognized as an avoidance to any claim of fraudulent practice or omission of material fact. Given good faith compliance with the Commission's recommendation⁷² and adequate demonstration of disclosure,⁷³ there is no reason to find issuer liability for fraudulent activity.⁷⁴

Absent the anti-fraud problem, the major function of the restrictive legend and the stop-transfer instruction in the context of federal law is notice.⁷⁵ By providing notice of private offering to prospective offerees the issuer demonstrates intent through recommended action consistent with the § 4(2) exemption to registration. Similarly, although omitted from the Commission's recommended action, through the letter acknowledging that he is familiar with the nature of the offering and the restrictions of Rule 144 and that he understands that "any person" engaging in secondary distribution of privately placed securities without giving notice to the secondary offeree is acting fraudulently,⁷⁶ the original offeree both evidences his participation in a private placement⁷⁷ and may be reminded of his own potential liability.

The question of offeree indemnification of the issuer as evidenced by the letter of intent is worthy of some attention at this point. The recent Commission emphasis on the fraudulent nature of failure to give notice of restrictions on transfer suggests that if the issuer does not comply with the Commission recommendations it may have difficulty in enforcing an

⁶⁹ SEC Securities Act Release No. 5223 (Jan. 11, 1972).

⁷⁰ SEC Securities Act Release No. 5121 (Dec. 30, 1970).

⁷¹ SEC Securities Act Release No. 5226, Exchange Act Release No. 9444 (Jan. 10, 1972).

⁷² See by analogy the last sentence of Securities Act § 19(a) (acts done in good faith in conformity with rule or regulation of Commission are valid).

⁷³ This suggests that consideration might be given to expanding the legend to include language directed more pointedly at Rule 144. While demonstration of original offeree intent may be covered by the letter (a purpose perhaps reflected in the recent alternative label "non-distribution letter"), notice to potential secondary offerees would be assured by slight expansion of the legend.

⁷⁴ Again, had the Commission taken a direct route (which it often avoids), had it proclaimed that absence of legend and stop-transfer order would be presumptive evidence against the fact of private distribution, this problem would not have arisen.

⁷⁵ This point also implies notice to prospective purchasers and to their dealers in respect to the title provisions of Article 8. See the discussion of U.C.C. § 8-204 in section V *infra*.

⁷⁶ SEC Securities Act Release No. 5226, Exchange Act Release No. 9444 (Jan. 10, 1972). This again suggests the inclusion of appropriate language in the letter of intent, another factor to be negotiated prior to closing.

⁷⁷ C. ISRAELS, CORPORATE PRACTICE § 16.11 (2d ed. 1969). But see *United States v. Custer Channel Wing Corp.*, 376 F.2d 675, 679 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967).

indemnification contract with its offerees.⁷⁸ Thus, even if the offeree signs a letter which recites an agreement to indemnify⁷⁹ the issuer for expenses occasioned by liability for registration or rescission under §§ 5 and 12 of the Securities Act,⁸⁰ the validity of the agreement should be questioned unless the particular offeree's actions are the reason for issuer liability. If the issuer is not blameless—which is not to say culpable—offeree conduct should not justify enforcement of an indemnification agreement.⁸¹

The issuer will have similar difficulties in limiting through use of the restriction devices its liability under § 12 of the Securities Act. Initially it may be noted that an *in pari delicto* defense to § 12 liability has been rejected even as asserted against an offeree who participated in the distribution.⁸² The judicial unwillingness to permit issuer limitations on § 12 liability by agreement follows an arguably too broad reading of *Wilko v. Swan*,⁸³ in which the Supreme Court read § 14 of the Securities Act to preclude an arbitration agreement limitation on application of § 12(2). In the case of the blameless issuer as against the distributing offeree the *Wilko* doctrine could be modified without violence to the language or purpose of the Securities Act. First, § 14 precludes waivers of "compliance with any provision";⁸⁴ it does not preclude limits on assertion of a *right* to rescission. Second, while agreement to arbitrate may infringe upon court jurisdiction over alleged violations of the Securities Act,⁸⁵ prospective waiver of a right of rescission for an offeree whose own conduct will violate the Act, while the issuer's will not, does no violence to the jurisdiction of the courts, because proof of the ancient "clean hands" in the application of this equitable remedy would imply court involvement. Finally, the aims of

⁷⁸ *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969) (by analogy, knowledge of misstatements precludes underwriter indemnity).

⁷⁹ An indemnification limited in the first instance by the depth of the offeree's pocket.

⁸⁰ As recommended by C. Israels, *Some Commercial Overtones of Private Placement*, 45 VA. L. REV. 851 (1959), rev. in SELECTED ARTICLES ON FEDERAL SECURITIES LAW 125, 138 n.65 (ABA 1968).

⁸¹ *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir.), *cert. denied*, 344 U.S. 856 (1952) (by analogy; underwriting agreement unenforceable as against public policy against an underwriter with knowledge of misleading statements). Parenthetically, it may be that the broker dealer does not come off so well; the broker's exemption will be denied where the broker has knowledge that the issuer is engaged in public distribution. *In re Quinn & Co.*, SEC Securities Exchange Act Release No. 9062 (Jan. 25, 1971). *See also* *In the Matter of Stone, Summer & Co.*, SEC Exchange Act Release No. 9839 (Nov. 3, 1972) and note 60 *supra*.

⁸² *Can-Am Petroleum Co. v. Beck*, 331 F.2d 371 (10th Cir. 1964). It should be noted, however, that there was no question before that court that the distribution violated § 5 of the Securities Act. A distinguishing feature, albeit a weak one, may exist where the offeree against whom the defense is asserted is the sole reason for issuer violation of § 5. *See* *Demarco v. Edens*, 390 F.2d 836, 841 n.3 (2d Cir. 1968) *citing* 185 F. Supp. 943, 946 (S.D. Cal. 1960), as to an immediate offeree limitation on § 12 remedies.

⁸³ 346 U.S. 427 (1953).

⁸⁴ Securities Act § 14 (emphasis added).

⁸⁵ *Shapiro v. Jaslow*, 320 F. Supp. 598 (S.D.N.Y. 1970) *citing* *Wilko v. Swan*, 346 U.S. 427 (1953).

the securities laws are not served by allowing offerees who knowingly engage in secondary distributions to profit from their misconduct.

Whatever the validity of the foregoing, the current outlook for issuer contractual limitation of liability is bleak at best. As has been outlined, however, the private placement issuer can substantially reduce potential liability arising out of the risk of public offering if it makes full use of legends, stop-transfer orders and letters of investment intent.⁸⁰ This is not to suggest that if the private placement issuer fails to employ the devices it is per se in violation of either § 10b of the Exchange Act or § 5 of the Securities Act. Faced with the risk of public distribution, however, the issuer can make drastic reductions in the scope of its potential liability if it employs the three transfer restricting devices. By contrast, failure to employ the devices may help precipitate disaster in the forms of (1) rescission rights in favor of all offerees,⁸⁷ (2) prosecution for willful violation of the Securities and Exchange Acts,⁸⁸ (3) liability to its transfer agent,⁸⁹ (4) liability under the anti-fraud provisions,⁹⁰ and (5) considerable examination by federal (and state) agencies with attendant public embarrassment. It may be noted that the careless attorney for the issuer is courting liability under the anti-fraud provisions and possibly a malpractice action.⁹¹

An example of the nightmarish possibilities flowing from failure to employ the restrictive devices is provided by *Mattson v. Medical Development Corp.*⁹² One of defendant Medical Development's shareholders owned 5,000 shares distributed under the private placement exemption to § 5 of the Securities Act, 1,000 of which were unlegended. Plaintiff shareholder apparently sought to dispose of his unlegended shares but was prevented from completing the transaction because of Medical Development's stop-transfer instruction to its transfer agent. The shareholder brought an action in state court, established his status as a bona fide purchaser without notice and won an order to the transfer agent to convert the shares to unrestricted. Meanwhile, Medical Development was informed by the Commission that failure to retain the restriction in force

⁸⁰ Full use implies full planning; it is unwise to introduce the legend and investment letter at closing. It is worthy of note that effective (but subject to considerations set forth in notes 73 and 76 *supra*) forms for private placements are set forth in Appendix B of C. ISRAELS & E. GUTTMAN, *MODERN SECURITIES TRANSFERS* (rev. ed. 1971). Sample certificate legends and an agreement to register under § 5 of the Securities Act are set forth in *WHEN CORPORATIONS GO PUBLIC* 21-23, Appendix A at 256 (C. Israels & G. Duff, eds., PLI 1962).

⁸⁷ Securities Act § 12. But see note 82 *supra*. See F. Klink, *Compliance with the Securities Act of 1933, HOW TO DO A PRIVATE OFFERING—USING VENTURE CAPITAL* 121, 124 (A. Sommer, ch., PLI 1970).

⁸⁸ Securities Act § 24, Exchange Act § 32(a).

⁸⁹ See section IV *infra*.

⁹⁰ Securities Act § 17; Exchange Act § 10b.

⁹¹ See the discussion in Section IIIB *supra*, particularly at note 60.

⁹² 329 F. Supp. 304 (D. Utah 1971) (a case citing neither Article 8 nor the Securities Act).

would result in a violation of federal law. Medical Development then obtained a stay of the state court order and brought a third party complaint against the Commission which was removed to federal court. The reported opinion is the court's dismissal on Commission motion of that complaint. The federal court, informed by the Commission that a no-action letter would not be issued,⁹³ remanded to the state court noting that the latter forum had better opportunity to rectify the difficulties presented.⁹⁴

Medical Development illustrates that failure to legend certificates can result, in the broadest sense, in a state court order to violate federal law. The examination of the state law under which such orders may be given, Article 8 of the Uniform Commercial Code, comprises the remainder of this discussion. Again, it should be kept in mind that a central question is whether Article 8 can provide adequate protection for the private placement issuer.⁹⁵

IV. ARTICLE EIGHT GENERALLY⁹⁶

'A. *The Intent and Coverage of Article 8*⁹⁷

"Article Eight's overriding objective is to confer full negotiability upon all investment securities . . ."⁹⁸ Thus, securities governed by the article are negotiable instruments.⁹⁹ The Article is "private law,"¹⁰⁰ and is

⁹³ The court certainly could not have denied the motion under the exhaustion of remedies doctrine. 329 F. Supp. at 306.

⁹⁴ While this position may be defensible in the context of these facts, it has serious limitations because state courts by expertise are hardly in a position to determine qualification for exemption from § 5 of the Securities Act, although such actions would normally fall within the concurrent jurisdiction provisions of § 22(a).

⁹⁵ Assuming, for the sake of argument, that state law restrictions were utilized fully in securities practice.

⁹⁶ Explanations of Article 8 generally include: C. BUNN, H. SNEAD & R. SPEIDEL, AN INTRODUCTION TO THE UNIFORM COMMERCIAL CODE §§ 3.18-3.24 (1964); E. Guttman, *Article 8—Investment Securities*, 17 RUTGERS L. REV. 136 (1962); C. Israels, *Investment Securities Problems—Article 8 of the U.C.C.*, 11 HOW. L.J. 120 (1965); C. Israels, *Investment Securities in New York: Statutory Text and Commercial Practice*, 48 CORNELL L.Q. 108 (1962); C. Israels, *Investment Securities as Negotiable Paper*, 13 BUS. LAW. 676 (1958), in UNIFORM COMMERCIAL CODE HANDBOOK 211 (ABA 1964); T. Jolls, *Investment Securities*, 22 BUS. LAW. 734 (1967); F. Leary, *Security Issues and Transfers Under the Uniform Commercial Code*, 2 U.C.C.L.J. 7 (1969); W. Wyatt, *Investment Securities—Article 8 of the Uniform Commercial Code*, 48 KY. L.J. 333 (1960). One excellent work discusses the premise underlying Article 8 in some depth. E. Folk, *Article 8: A Premise and Three Problems*, 65 MICH. L. REV. 1379 (1967).

⁹⁷ Three preliminary points are worthy of note prior to discussion of the Code. First, the section captions are part of the Code. U.C.C. § 1-109. Second, the Code imposes an obligation of good faith, U.C.C. § 1-203, and while the effect of the provisions of the Code may be varied by agreement, this obligation may not be disclaimed. U.C.C. § 1-102(3). Third, "[t]he Code is the legislation; the Comments are not." R. NORDSTROM & N. LATTIN, *SALES AND SECURED TRANSACTIONS* 17-18 (1968).

⁹⁸ E. Folk, *Article Eight: A Premise and Three Problems*, 65 MICH. L. REV. 1379, 1379 (1967).

⁹⁹ U.C.C. § 8-105(1).

"neither a Blue Sky law nor a corporation code."¹⁰¹ The Article continues the long standing view of certificates as personal property *and* evidence of the shareholder's interest in the issuing company.¹⁰²

The Article 8 definition of security is one of function and not of form:

A "security" is an instrument which (i) is issued in bearer or registered form; and (ii) is of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment; and (iii) is either one of a class or series or by its terms is divisible into a class or series of instruments; and (iv) evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.¹⁰³

It is immediately evident that the Article 8 definition of a security is not so broad as is that contained in the Securities Act.¹⁰⁴ Thus while a contract for the sale of undivided interests in land could be a security under the Securities Act,¹⁰⁵ that contract probably would not be subject to Article 8. On the other hand, any instrument qualifying as a security under Article 8 would fit within the Securities Act.¹⁰⁶ One federal court suggested, but did not hold, that savings and loan association certificates are covered by Articles 3 and 8.¹⁰⁷

While Article 8 makes securities negotiable,¹⁰⁸ it should not be assumed that "negotiable" has the same meaning or effect in Article 8 as in Article 3. There is some similarity, for example, in the presumption in favor of validity of signatures,¹⁰⁹ which has lead at least one court both to observe that Article 8 is insufficiently detailed, requiring the application of Article 3 to arrive at the conclusion that a principal could not be a holder in due course if its agent were not.¹¹⁰ This conclusion, if extended, could result in an allocation of loss more consistent with Article 3's scheme

¹⁰⁰ Which makes questionable a prediction employing an analogy to BarChris liability for failure to investigate. F. Leary, *Security Issues and Transfers Under the Uniform Commercial Code*, 2 U.C.C.L.J. 7 (1969).

¹⁰¹ U.C.C. § 8-101 Comment.

¹⁰² See, e.g., *Morris v. Hussong Dyeing Mach. Co.*, 81 N.J. Eq. 256, 86 A. 1026 (1913).

¹⁰³ U.C.C. § 8-102(1)(a); C. BUNN, H. SNEAD & R. SPEIDEL, *AN INTRODUCTION TO THE UNIFORM COMMERCIAL CODE* § 3.18. "Registered form" is defined in U.C.C. § 8-102(1)(c).

¹⁰⁴ Compare Securities Act § 2(1).

¹⁰⁵ See *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

¹⁰⁶ C. Israels, *Stop-Transfer Procedures and the Securities Act of 1933—Addendum to Uniform Commercial Code—Article 8*, 17 RUTGERS L. REV. 158 (1962), rev. in *SELECTED ARTICLES ON FEDERAL SECURITIES LAW* 231, 232 (ABA 1968).

¹⁰⁷ *Abraham Lincoln Ins. Co. v. Franklin Sav. & Loan Ass'n*, 302 F. Supp. 54 (E.D. Mo. 1969). An interesting approach given the mutual exclusiveness of the two articles. See note 112 *infra*.

¹⁰⁸ U.C.C. § 8-105(1).

¹⁰⁹ U.C.C. §§ 3-307, 8-105(2).

¹¹⁰ *E. F. Hutton & Co. v. Manufacturers Nat'l Bank*, 259 F. Supp. 513 (E.D. Mich. 1966), noted in 6C W. WILMER and F. HART, *U.C.C. REP.-DIGEST* ¶ 2-1459, A3 (1972). Moreover, the case involved warrants, which are included within the scope of Article 8. U.C.C. § 8-102 Comment.

than with Article 8's. Excessive use of Article 3 to interpret Article 8 may lead to unfortunate results.¹¹¹ First, both articles provide for the exclusive application of Article 8 to negotiable securities.¹¹² Moreover, Article 8's functional definition of investment securities differs from Article 3's form definition of negotiable instruments;¹¹³ the former article does not employ the holder in due course concept while the latter does;¹¹⁴ the former recognizes issuer limitations on transferability while speaking generally the latter prohibits such limitations on negotiability by definition.¹¹⁵ These comparisons suggest that in investment securities cases where Article 3 and the law antecedent to Article 8 conflict, the result consistent with the latter is preferable.¹¹⁶

B. *Transfer and the Bona Fide Purchaser*

Both indorsement *and* delivery¹¹⁷ are required for transfer of a security,¹¹⁸ although as between immediate parties a delivery without indorsement is effective and confers a right to compel indorsement¹¹⁹ and thus transfer. By the same token an indorsement in blank without delivery will not constitute a transfer.¹²⁰ While courts often speak of the process of registration by the issuer or its transfer agent as "transfer," this term is not descriptive of the process. The agent *registers* (not to be confused with registration under § 5 of the Securities Act) the transfer;¹²¹ he does not and cannot effect or approve transfer. After "the security is both indorsed and delivered, the 'transfer' as between the parties is complete, whether or not the issuer has recognized the fact of change of ownership."¹²² Thus the change of ownership does not depend upon lack of registration on the issuing corporation's books,¹²³ and death of a transferor between delivery and registration has no effect on the validity of the

¹¹¹ T. Jolls, *Investment Securities*, 22 BUS. LAW. 734 (1967).

¹¹² U.C.C. §§ 3-101, 3-103(1), 3-103 Comment 2, 8-102(1)(b).

¹¹³ Compare U.C.C. § 8-102(1)(a) with U.C.C. §§ 3-104(1) and 3-105-111.

¹¹⁴ U.C.C. § 3-302. This observation notwithstanding, a New Jersey court in setting forth a broker's lack of affirmative duty to cancel a transaction on behalf of its customer stated that the purchaser was a holder in due course with respect to the securities transferred. *White v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 90 N.J. Super. 565, 218 A.2d 655 (1966) citing N.J.S. 12A: 3-302.

¹¹⁵ Compare U.C.C. § 8-204 with U.C.C. §§ 3-104, 105.

¹¹⁶ See generally C. Israels, *Investment Securities as Negotiable Paper*, 13 BUS. LAW. 676 (1958), in UNIFORM COMMERCIAL CODE HANDBOOK 211 (ABA 1964).

¹¹⁷ U.C.C. § 1-201(14).

¹¹⁸ U.C.C. § 8-309; *Liss v. Liss*, 355 Mass. 787, 243 N.E.2d 923 (1969).

¹¹⁹ U.C.C. § 8-307; *Goldammer v. Fredricks*, 70 Ill. App. 2d 398, 217 N.E.2d 290 (1966).

¹²⁰ *Whitfield v. Metropolitan Life Ins. Co.*, 262 F. Supp. 977 (W.D. Ark. 1967).

¹²¹ U.C.C. § 8-401(1). Which suggests that from the standpoint of state law, the Commission's emphasis on stop-transfer orders may be overdone.

¹²² C. Israels, *Investment Securities as Negotiable Paper*, 13 BUS. LAW. 676 (1958), in UNIFORM COMMERCIAL CODE HANDBOOK 211, 218 (ABA 1964).

¹²³ *Toigo v. Ross*, 107 Ill. App. 2d 395, 246 N.E.2d 68 (1969).

transfer.¹²⁴ Moreover, record ownership is not a requisite to the owner's enforcement of his rights under the certificate.¹²⁵ It follows, then, that the issuer which legends its certificates with a phrase such as "transferable only on the books of the corporation" has wasted its ink.¹²⁶

This distinction between transfer and registration of transfer is the reason for the state court's order in *Medical Development*¹²⁷ that the transfer agent register transfer even in the face of assertions that the Commission would look upon the registration as a violation of the Securities Act. One of the requisites to imposing the issuer's duty to register transfer is that "the transfer is in fact rightful *or* is to a bona fide purchaser."¹²⁸ Thus a bona fide purchaser satisfying § 8-401 may compel registration of a transfer which is not rightful. "Bona fide purchaser" is defined as "a purchaser for value¹²⁹ in good faith¹³⁰ and without notice of any adverse claim who takes delivery . . ."¹³¹ The bona fide purchaser takes the security free of any adverse claim,¹³² whereas the limited purchaser's interest¹³³ may not include the right to compel registration of transfer. Accordingly, the question of bona fide purchaser status is one of fact,¹³⁴ and where certificates were issued without authority the right of the purchaser to compel registration of transfer turned on notice and knowledge¹³⁵ as a question of fact.¹³⁶

The issuer is subject to liability for wrongful registration of transfer,¹³⁷ and the duty to register¹³⁸ is accompanied by liability for unreasonable delay¹³⁹ or failure to register.¹⁴⁰ The issuer's liability for failure to regis-

¹²⁴ Wade-Corry Co. v. Moseley, 223 Ga. 474, 156 S.E.2d 64 (1967).

¹²⁵ New England Merchants Nat'l Bank v. Old Colony Trust Co., 356 Mass. 612, 254 N.E.2d 891 (1970).

¹²⁶ C. Israel, *Investment Securities Problems—Article 8 of the U.C.C.*, 11 How. L.J. 120, 127 (1965). Although such a legend might be construed as a contract between issuer and purchaser, it will not affect transfer or validity of the security. See U.C.C. § 8-202(1).

¹²⁷ Mattson v. Medical Dev. Corp., 329 F. Supp. 304 (D. Utah 1971). See the discussion accompanying notes 92 to 95 *supra*.

¹²⁸ U.C.C. § 8-401(1) (e) (emphasis added).

¹²⁹ U.C.C. § 1-201(44).

¹³⁰ U.C.C. § 1-201(19).

¹³¹ U.C.C. § 8-302 (footnotes added).

¹³² U.C.C. § 8-301(2).

¹³³ U.C.C. § 8-301(3).

¹³⁴ Gwatney v. Allied Companies, Inc., 238 Ark. 962, 385 S.W.2d 940 (1965); United States Fidelity & Guaranty Co. v. Goetz, 285 N.Y. 74, 32 N.E.2d 798, 27 N.Y.S.2d 31 (1941).

¹³⁵ U.C.C. § 1-201(25-27).

¹³⁶ Dempsey-Tegeler & Co. v. Otis Oil & Gas Corp., 293 F. Supp. 1383 (D. Colo. 1968).

¹³⁷ U.C.C. § 8-404(2).

¹³⁸ U.C.C. § 8-401(1).

¹³⁹ Holmes v. Birtman Elec. Co., 18 Ill. 2d 554, 165 N.E.2d 261 (1960) (action by survivor joint tenant against transfer agent; five month delay is unreasonable).

¹⁴⁰ U.C.C. § 8-401(2); see generally Annot., 75 A.L.R.2d 746 (1961) ("Right or duty of corporation to refuse to transfer stock on presentation of properly indorsed certificates, because of conflicting rights or claims of one other than transferee").

ter the transfer or for delay in registration is dependent, however, upon proof of damages,¹⁴¹ and does not include counsel fees.¹⁴² Privately placed securities acquired as collateral on a debt may raise the issue of issuer liability for failure to register¹⁴³ but, again, bona fide purchaser status is required to compel the registration.¹⁴⁴ The transfer agent is liable to the holder jointly with the issuer for failure to register transfer¹⁴⁵ but proof of loss is a requisite to recovery of damages.¹⁴⁶ The transfer agent is required, however, to act within a reasonable time if it is to avoid liability, and delay occasioned by an issuer president's personal whim and agent failure to recognize a Commission no-action letter is unjustified delay.¹⁴⁷

V. TRANSFER RESTRICTIONS IN THE CONTEXT OF ARTICLE EIGHT¹⁴⁸

A. *Provisions for Restriction on Transfer*

The issuer's ability to restrict transfer of its securities antedates the Code. The common law and the Uniform Stock Transfer Act permitted

¹⁴¹ *Berman v. Airlift Int'l, Inc.*, 302 F. Supp. 1023 (N.D. Ga. 1969) (right of action recognized; motion for summary judgment granted because no damages). See also *Riskin v. National Computer Analysts, Inc.*, 62 Misc. 2d 605, 308 N.Y.S.2d 985 (1970); *Linder v. Continental Stock Transfer Corp.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,614 (N.Y. Sup. Ct. 1965).

¹⁴² *Rosenberg v. Nathan Benjamin, Inc.*, 49 Pa. D. & C.2d 188 (1969). U.C.C. § 8-204, Comment 3.

¹⁴³ *Branerton Corp. v. United States Corp.*, 34 App. Div. 2d 1, 309 N.Y.S.2d 28 (1970) (remanding on defendant's assertion that a "no-action" letter was required). The application of Rule 144, however, may reduce the monetary value of the right of a lending institution to compel registration of transfer. See note 39 *supra*.

¹⁴⁴ *Brown v. Rosetti*, 66 Misc. 2d 239, 319 N.Y.S.2d 1001 (1971) (factor firm which took stolen securities outside the "usual course of business" failed to qualify as a bona fide purchaser).

¹⁴⁵ U.C.C. § 8-406; U.C.C. § 8-406, Comment 1; *Welland Investment Corp. v. First Nat'l Bank*, 81 N.J. Super. 180, 195 A.2d 210 (1963).

¹⁴⁶ *Bayer v. Airlift Int'l, Inc.*, 111 N.J. Super. 461, 268 A.2d 548 (1970).

¹⁴⁷ *Kanton v. United States Plastics, Inc.*, 248 F. Supp. 353 (D.N.J. 1965). Parenthetically, the broker is not a party to this liability; although he may be forced to "cover," U.C.C. § 8-313(3), his action in good faith will not make him liable in conversion, U.C.C. § 8-318. The "know your customer rule," however, may impose liability for conversion of stolen securities. *Hartford Acc. & Indem. Co. v. Walston & Co.*, 21 N.Y.2d 218, 234 N.E.2d 230, 287 N.Y.S.2d 58 (1967) (decided on N.Y. PERS. PROP. L. § 168 but consistent with Article 8). The broker is not subject to the Article 8 statute of frauds. U.C.C. § 8-319; *Lindsey v. Stein Bros. & Boyce, Inc.*, 59 Tenn. App. 727, 443 S.W.2d 669 (1968). For a discussion of transfer agent liability under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1971), see note 60 *supra*.

¹⁴⁸ Discussions focusing on Article 8 restrictions on transferability in the context of federal securities law include: C. ISRAELS & E. GUTTMAN, *MODERN SECURITIES TRANSFERS* (rev. ed. 1971); C. ISRAELS, *CORPORATE PRACTICE* §§ 4.33-4.34, 16.01-16.12 (2d ed. 1969); C. ISRAELS, *How to Handle Transfers of Stock, Bonds, and other Investment Securities*, 19 BUS. LAW. 90 (1963), in *UNIFORM COMMERCIAL CODE HANDBOOK* 229 (ABA 1964); C. ISRAELS, *Stop-Transfer Procedures and the Securities Act of 1933—Addendum to Uniform Commercial Code—Article 8*, 17 RUTGERS L. REV. 158 (1962), rev. in *SELECTED ARTICLES ON FEDERAL SECURITIES LAW* 231 (ABA 1968); Annot., 21 A.L.R.3d 964 (1968) ("Construction and Effect of U.C.C. Art. 8, Dealing with Investment Securities"); Annot., 75 A.L.R.2d 746 (1961) ("Right or duty

restrictions on transfer if these were reasonable and not against public policy, and were accompanied by adequate notice to purchasers.¹⁴⁹ Thus, an issuer who failed to register transfer of a security where legal notice of a reasonable restriction was not given was liable in conversion,¹⁵⁰ where the purchaser took with notice, a reasonable restriction would be sustained.¹⁵¹ The two requisites of reasonableness and compliance with public policy and of notice exist in current law. The first of these is not codified; the second has been specifically carried into Article 8.

The reasonableness and not against public purpose side of this doctrine is rooted in history in the reservation of a right of first refusal, a restriction of long¹⁵² and continued¹⁵³ vitality antedating the Securities Act. No case has been found in which the validity of restrictions imposed to insure issuer compliance with the Securities Act has been discussed. It is obvious, however, that such restrictions are more or less taken to be valid within the confines of Article 8. First, however, restrictions on alienation of securities are not universally favored outside the Code. In the context of an action for refund of income tax paid, for example, one court held that transfer for tax purposes was to be reckoned in the year of execution of an agreement to buy unregistered securities, even though negotiations were still in progress with the Commission to avoid liability under § 5 of the Securities Act and there would have been no delivery,¹⁵⁴ and hence no enforceability of the agreement, under Article 8.¹⁵⁵ When coupled with the Securities Act prohibition of public *offering*, this view of transferability of securities or interests therein would satisfy violation of §

of corporation to refuse to transfer stock on presentation of properly endorsed certificates, because of conflicting rights or claims of one other than transferee"); Annot., 29 A.L.R.2d 901 (1935) ("Construction and effect of § 15 of Uniform Stock Transfer Act prohibiting restriction on transfer of shares unless such restriction is stated in the certificate") (pre-Code history of U.C.C. § 8-204).

¹⁴⁹ Section 15 of the Uniform Stock Transfer Act required that the restriction be printed on the certificates. *People v. Galskis*, 233 Ill. App. 414 (1924).

¹⁵⁰ *Hulse v. Consolidated Quicksilver Mining Corp.*, 65 Idaho 768, 154 P.2d 149 (1944).

¹⁵¹ *Tomoser v. Kamphausen*, 307 N.Y. 797, 121 N.E.2d 622, 147 N.Y.S.2d 241 (1954). Other pre-Code cases dealing with reasonableness and notice of restrictions include: *In re Consolidated Factors Corp.*, 46 F.2d 561 (S.D.N.Y. 1931); *Vannucci v. Pedrini*, 217 Cal. 138, 17 P.2d 706 (1933); *Mancini v. Patrizi*, 110 Cal. App. 42, 293 P. 828 (1930); *Malcolm v. Lake Sand Corp.*, 251 Ill. App. 499 (1929); *New England Trust Co. v. Abbott*, 162 Mass. 148, 38 N.E. 432 (1894); *Costello v. Farrell*, 234 Minn. 453, 48 N.W.2d 557 (1951); *Baumohl v. Goldstein*, 95 N.J. Eq. 597, 124 A. 118 (1924); *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957).

¹⁵² *People v. Galskis*, 233 Ill. App. 414 (1924).

¹⁵³ *Cimo v. National Motor Club*, 237 So. 2d 408 (La. App. Ct. 1970).

¹⁵⁴ See section IVB *supra*. The tax year in question was 1959.

¹⁵⁵ *Stoner v. United States*, 313 F. Supp. 1383 (N.D. Ill. 1970). The Supreme Court has held through somewhat analogous reasoning that loss-carryback tax refund claims were property which passed to a trustee in bankruptcy under § 70a(5) of the Bankruptcy Act, 11 U.S.C. § 110(a)(5) (1970); *Segal v. Rochelle*, 382 U.S. 375 (1966). However, in this case unlike *Stoner*, the Court was dealing with rights assignable under state law.

5 no matter what the status of restrictive legends, stop-transfer orders and letters of investment intent.

Second, the language of Article 8 must be strained to support restrictions not relating to ownership of securities. The bona fide purchaser for value may demand registration of even non-rightful transfer,¹⁵⁶ subject to the precondition (among others) that the issuer has no duty to inquire into adverse claims,¹⁵⁷ which term "includes a claim that a transfer was or would be wrongful or that a particular person is the owner of or has an interest in the security."¹⁵⁸ Absent use of a legend or actual knowledge, there is no way for the issuer to avoid registration of transfer where the purchase is bona fide. But even with use of the legend, there is some question that the generally accepted legend form relating to transfer restrictions imposed by the Securities Act gives notice of an "adverse claim" under Article 8 or makes a transfer "wrongful." These two terms relate, in history and as explained in the comments, to claims of ownership. And even if transfer in violation of the Securities Act is wrongful, the Comments provide:

If the security is properly indorsed but nevertheless the transfer is in fact wrongful, there is no duty [to register] *unless* the transfer is to a bona fide purchaser¹⁵⁹

Third, although well reasoned commentary suggests otherwise,¹⁶⁰ the use of Article 8 to impose restrictions contrary to its basic purpose and not related to claims of ownership strains the meaning and intent of its provisions and purpose.¹⁶¹ Whatever the validity of this conclusion, the private placement issuer cannot foreclose the duty to register transfer unless it insures that offerees are not bona fide purchasers. This consideration leads to the notice side of the restriction doctrine.

Unless noted conspicuously¹⁶² on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person¹⁶³ with actual knowledge¹⁶⁴ of it.¹⁶⁵

¹⁵⁶ See Section IVB *supra*.

¹⁵⁷ U.C.C. § 8-401(1)(c).

¹⁵⁸ U.C.C. § 8-301(1). The comments to this section contain no reference to federal securities law. Indeed, that law is referenced in the comments to the whole of Article 8 only three times.

¹⁵⁹ U.C.C. § 8-401, Comment 3 (emphasis added) *citing* *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir.), *cert. denied*, 344 U.S. 856 (1952).

¹⁶⁰ E. Folk, *Article Eight: A Premise and Three Problems*, 65 MICH. L. REV. 1379, 1399 (1967).

¹⁶¹ This suggests, as Professor Loss suggested some time ago, that a right of first refusal might be recited in the legend of all offerees whose investment intent motives are suspicious. 1 LOSS, SECURITIES REGULATION 671-73 (1961).

¹⁶² U.C.C. § 1-201(10); see C. Israel's, *Investment Securities Problems—Article 8 of the U.C.C.*, 11 HOW. L.J. 120, 129-31 (1965).

¹⁶³ U.C.C. § 1-201(30).

¹⁶⁴ U.C.C. § 1-201(25)-(27).

¹⁶⁵ U.C.C. § 8-204 (footnotes added). No state has changed the official text language of this

One of the comments to this section assumes that the restriction provided for will be used to comply with the Securities Act in just this context.¹⁶⁶ Thus, whether or not violation of the Securities Act constitutes a wrongful transfer or adverse claim, it does not do violence to the drafters' intent to read as valid restrictions grounded in the Securities Act and effected through § 8-204. The effect of this statutory notice is of course that the purchaser of the validly legended certificate is not a bona fide purchaser in relation to the subject of the legend. Similarly, a letter of investment intent could recite offeree knowledge of the restriction but would afford the issuer no protection from the claims of secondary offerees. This consideration in turn raises the question of the circumstances which will justify imposition of restrictions where the issuer has neglected to legend the certificates.

B. *Transfer Restrictions in the Context of Present Practice*

The question of whose counsel is to give the opinion that further distribution of privately placed shares will not violate the Securities Act¹⁶⁷ has been avoided by recognition of the problem by the securities bar and by the adoption of Rule 144. The problem of implied offeree consent to receive legended certificates, however, may still have some vitality.

section. 3 R. ANDERSON, UNIFORM COMMERCIAL CODE 700-02 (1971); 2 UNIFORM LAWS ANN. (Uniform Commercial Code) 617-22 (West 1968 and Supp. 1972). Moreover, the courts appear to apply § 8-204 accurately. See, e.g., *Sellers v. Sellers*, 428 P.2d 230 (Okla. 1967) (oral contracts for right of first refusal); *Perugina v. Samson Land & Dev. Co.*, 39 Pa. D. & C.2d 500 (1965) (failure to note restriction on shares). U.C.C. § 8-301 is a similar provision respecting issuer liens.

¹⁶⁶ U.C.C. § 8-204, Comment 3. The comment following notes that the section does not apply to restrictions imposed by statute. U.C.C. § 8-204, Comment 4. This raises the question whether the restrictions of which the Commission wants notice given, *vis.*, those imposed by Rule 144, are imposed by statute on the issuer. The same question in another context may be posed by state corporation law. For example, OHIO REV. CODE ANN. § 1701.25(B) (Page Supp. 1971) provides:

(B) No restriction on the right to transfer shares and no reservation of lien on shares shall be effective against a transferee of such shares unless there is set forth on the face or the back of the certificate therefor:

- (1) A statement of the terms of such restrictions or reservations; or
- (2) A summary of the terms of such restriction or reservation and a statement that the corporation will mail to the shareholder a copy of such restriction or reservation without charge within five days after receipt of written request therefor; or
- (3) If such restriction or reservation is contained in the articles or regulations of the corporation, or in an instrument in writing to which the corporation is a party, a statement to that effect and a statement that the corporation will mail to the shareholder a copy of such restriction or reservation without charge within five days after receipt of written request therefor; or
- (4) If such restriction or reservation is contained in an instrument in writing (other than the articles or regulations of the corporation or an instrument in writing to which the corporation is a party), a statement to that effect identifying the instrument by title, date, and parties.

It is to be noted that the language set forth does not provide for purchaser actual knowledge, as does U.C.C. § 8-204.

¹⁶⁷ See *Petrillo v. Seven Arts Prod., Ltd.*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,921 (N.Y. Sup. Ct. 1967).

Without discussion of the Code or federal law, one court has held that in the context of an employee stock option plan, the employee's agreement to acquire for investment and to sell only in compliance with the Securities Act evidenced consent to receive legended certificates.¹⁶⁸ This approach and conclusion were followed in the context of a private placement to refuse clean certificates in exchange for those legended with the words: "These shares were acquired for investment purposes."¹⁶⁹ Where an employee in a stock option plan had not understood the nature of the restrictions attendant to private placement, however, the issuer's failure to give notice precluded it from transferring legended shares under the option agreement.¹⁷⁰ This result begins to approach the failure to give notice of restrictions discussed above¹⁷¹ which the Commission will look upon as a violation of Rule 10b-5. Without citing the applicable release,¹⁷² one court has recently recognized a private right of action¹⁷³ under Rule 10b-5 for misrepresentation of the marketability of shares to be acquired, even where the offeree had signed a statement that he was taking for his own account and without intent to distribute.¹⁷⁴

The two themes of reasonableness and notice in issuer imposed restrictions are brought together in a state court opinion¹⁷⁵ holding invalid restrictions printed on the certificates but relating to the corporate articles.¹⁷⁶ The court's decision was based upon three grounds: (1) the legend on the front of the certificate referenced the back and the entire legend was in small print and unclear, *i.e.*, the legend was inconspicuous.¹⁷⁷ (2) The restriction was not reasonable because it required the approval of the New York Stock Exchange prior to transfer, "a third party not in privity . . . without any criteria for the exchange to be governed by, in giving or withholding consent, is clearly arbitrary, capricious, and un-

¹⁶⁸ *General Dev. Corp. v. Catlin*, 139 S. 2d 901 (Fla. Ct. App. 1962).

¹⁶⁹ *Short v. Soil Builders Int'l Corp.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,188 (Tenn. Ct. App. 1962). This court did discuss the issuer's attempt to comply with the Securities Act in making a private placement.

¹⁷⁰ *Altman v. American Foods, Inc.*, 262 N.C. 671, 138 S.E.2d 526 (1964) (distinguishing *Catlin* on the explicitness of the option agreement).

¹⁷¹ See section IIB *supra*.

¹⁷² SEC Securities Act Release No. 5226, Exchange Act Release No. 9444 (Jan. 10, 1972). Understandably since the decision postdates the release by four days.

¹⁷³ *Abdelnour v. Coggeshall & Hicks*, CCH FED. SEC. L. REP. ¶ 93,340 (S.D.N.Y. Jan. 14, 1972) (judgment for defendant over plaintiff's failure to prove reliance). But as to the reliance issue see *Affiliated Ute Citizens of Utah v. United States*, 92 S. Ct. 1456 (1972) and notes 60 and 67 *supra*.

¹⁷⁴ The recognition of this right of action is only a step away from the Commission's position on the applicability of Rule 10b-5 in this context. Clearly, employee stock option plans can and should be drafted with sufficient care to avoid the difficulty.

¹⁷⁵ *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 470 S.W.2d 441 (Tex. Civ. App. 1971).

¹⁷⁶ This in itself does not invalidate a legend under Article 8. U.C.C. § 8-202(1).

¹⁷⁷ U.C.C. §§ 8-204, 1-201(10).

reasonable."¹⁷⁸ (3) The restriction was not valid under the state's corporation law. The case suggests at the very least that there are limits to the restrictions which may be imposed by issuers and that drafting legends for special purposes deserves more than cursory attention.

This discussion has not as yet construed Article 8 to provide complete insurance for the private placement issuer against the risks of public distribution. The problems facing state courts called upon to order registration of transfers allegedly in violation of the Securities Act may be increased due to recent statements of Commission policy. In recent years the courts have relied unreservedly on Commission no-action letters in ordering transfer of registration thereof.¹⁷⁹ If the Commission is serious in its intent not to issue no-action letters in the private placement context,¹⁸⁰ the state courts will be faced with an even more difficult task¹⁸¹ of interpreting federal securities law and Commission pronouncements in light of Article 8. The alternatives of issuing orders requiring violation of federal law,¹⁸² backing off from decisions on the grounds of inability to decide federal securities law,¹⁸³ and misinterpreting Article 8 to permit an issuer which ignored legends to refuse to register transfer as against a bona fide purchaser, are as unattractive for the parties and their attorneys as these alternatives must be unpalatable to the state courts.¹⁸⁴

Given this situation the question of effectiveness of the three restricting devices in the private placement situation is again worthy of attention. Because transfer occurs under Article 8 independent of registration of it on the transfer agent's books,¹⁸⁵ and because a violation of the Securities Act should not be read into the Article to destroy the rights of a bona fide purchaser,¹⁸⁶ the effectiveness of restrictive legends, stop-transfer orders and letters of investment intent should be reviewed briefly.

First, it seems apparent that the Commission is willing to benchmark transfer at the point of registration of transfer under Article 8.¹⁸⁷ From

¹⁷⁸ 470 S.W.2d at 444.

¹⁷⁹ See *Kanton v. United States Plastics, Inc.*, 248 F. Supp. 353 (D.N.J. 1965); *Riskin v. National Computer Analysts, Inc.*, 62 Misc. 2d 605, 308 N.Y.S.2d 985 (1970); *Donlon Ventures, Inc. v. Avien, Inc.*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,961 (N.Y. Sup. Ct. 1967).

¹⁸⁰ SEC Securities Act Release No. 5223 (Jan. 11, 1972); SEC Securities Act Release No. 5186 (Sept. 10, 1971). The evidence to date suggests otherwise. See section IIB *supra*.

¹⁸¹ The advertised "definiteness" of Rule 144 notwithstanding. See section IIIC *supra*.

¹⁸² *Mattson v. Medical Dev. Corp.*, 329 F. Supp. 304 (D. Utah 1971).

¹⁸³ *Trad v. Hodes*, 72 N.J. Super. 306, 178 A.2d 247 (1962).

¹⁸⁴ The court's task will be much easier where the control person concept, Securities Act § 2(11), is involved, both because of the absence of direct issuer involvement in public distribution and because of Rule 144. See *Travis Inv. Co. v. Harwyn Publishing Corp.*, 288 F. Supp. 519 (S.D.N.Y. 1968), for one example of this context.

¹⁸⁵ See section IVB *supra*.

¹⁸⁶ See section VB *supra*. The effect of a contrary conclusion on marketplace negotiability of securities would be undesirable at best.

¹⁸⁷ This is implicit in the Commission's issuance of no-action letters in *Mattson v. Medical*

the point of view of issuer liability for public distribution, this is a desirable approach because it gives the issuer at least an opportunity to negotiate with the maverick offeree before an entire placement is declared to be in violation of § 5 of the Securities Act. Also, it is difficult to conceive how the Commission could effectively police secondary distributions absent examination of and reference to registration on transfer agents' books.

Second, because most transfers through brokers are registered prior to delivery, the legend and stop-transfer order will put both the issuer and the purchaser on notice of impending violation of the Securities Act. While the buying broker will have remedies in this situation, he will not deliver the restricted shares¹⁸⁸ to his client and can allow the issuer which has not given notice to avoid public distribution.¹⁸⁹

Whatever the position of broker and Commissioner, the strength of rights vested in the bona fide purchaser—a strength called for by considerations of market place negotiability—makes use of a valid legend nearly mandatory, particularly for the private placement issuer. Only by issuing legended certificates can the issuer insure that subsequent offerees do not assert bona fide purchaser rights against it. Moreover, the Commission's call for stop-transfer orders and the "scare" value of the indemnifying letter of investment intent justifies use of these additional devices.¹⁹⁰

Finally, because of recent Commission infusion of the anti-fraud provisions into the consideration of failure to notify offerees of transfer restrictions imposed by federal securities law, issuer liability may be only a step away from extension to the issuer's attorney. If the securities bar ignores this bit of reality, the Commission and the courts will not.

VI. CONCLUSION

While the Commission's current pronouncements on private offerings may have increased clarity of application in some sales of unregistered securities, they have created substantial areas of confusion, particularly for the small corporation attempting a private placement. Under the

Dev. Corp., 329 F. Supp. 304 (D. Utah 1971); *Travis Inv. Co. v. Harwyn Publishing Corp.*, 288 F. Supp. 519 (S.D.N.Y. 1968) and *Trad v. Hodes*, 72 N.J. Super. 306, 178 A.2d 247 (1962).

¹⁸⁸ See, e.g., NASD Uniform Practice Code § 56(a) (irregular delivery), (b) (reclamation because of transfer agent refusal to register). See also the NASD statement that a Form 144 and the Seller's requisite statement are not proper delivery; transfer of the certificate is required as well. National Association of Securities Dealers, Inc., Release of May 25, 1972, CCH FED. SEC. L. REP. ¶ 78,808.

¹⁸⁹ While the buying broker may insist on his customer's rights as a bona fide purchaser and force the seller's broker to cover, action on warranties, see U.C.C. § 8-313(3), and rescission is the preferable course to avoid public distribution. C. ISRAELS & E. GUTTMAN, *MODERN SECURITIES TRANSFERS* § 6.07 (rev. ed. 1971).

¹⁹⁰ See section IIIC *supra* for additional impact of these devices in the context of federal law.

body of federal securities law the attractiveness to the investor of privately placed securities is reduced and potential issuer liability is broadened, particularly under the anti-fraud provisions. Issuer protection afforded by Article 8 against the risk of public distribution is less clear than under prior law. It is clear, however, that the private placement issuer who permits offerees to take its shares as bona fide purchasers has incurred substantial risk where there is chance of public distribution. Use of legended certificates, stop-transfer instructions, and letters of investment intent is nearly mandatory.

Reliance by both the Commission and the bar on the restrictive devices of Article 8 requires more thorough examination than has previously been afforded it, because there is some doubt whether that Article provides the measure of protection which has been assumed. Moreover, the Commission's announced policy of not issuing no-action letters in the context of private placements may well increase the difficulties of state courts which must apply Article 8 in the face of federal securities laws, a task previously difficult enough given the gaps between the two bodies of laws.

It may be observed that the federal and state bodies of law do not dovetail perfectly because the Securities Act and the Uniform Commercial Code reach to different objectives. Employing the exceptions to Code transferability to comply with the Act may have some as yet unexplored pitfalls. To this extent, definitions of what constitutes private placement which were more in tune with possible issuer action would clarify the law, and delineated but unqualified requirements for the legend, stop-transfer order and letter of investment intent could create a rebuttable presumption that a private placement had occurred, thus giving state courts faced with actions to compel registration of transfer some ground upon which to determine wrongfulness of transfer.¹⁹¹

For the issuer's attorney, it is too obvious to be stated as a conclusion

¹⁹¹ The proposal for a single nationwide marketing system, Proposed Securities Transaction Processing Act of 1972, CCH FED. SEC. L. REP. No. 416, Special Rep. (Mar. 27, 1972); Future Structure of the Securities Markets, CCH FED. SEC. L. REP. No. 409, Special Rep. (Feb. 4, 1972), which grew out of the recently increased numbers of transactions and the paperwork and financial crises lamented by the Congress, SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 92D CONG., 2D SESS., SECURITIES INDUSTRY STUDY (for the period ended Feb. 4, 1972) (Comm. Print 1972), HOUSE SUBCOMM. ON COMMERCE AND FINANCE, 92D CONG., 2D SESS., SECURITIES INDUSTRY STUDY (Comm. Print 1972), may render moot some of the current reliance on the face of the certificate as providing notice of restrictions on transferability. So long as the private placement exemption turns in part on offeree intent, however, some means of issuer protection in the form of a transfer restricting device will still be required. Moreover, a proposed law governing national systems to streamline transfers gives the Commission broad rule making power. It is to be hoped that the Commission drafts its rules in light of Article 8. Consider for example the potential effects on the body of states' commercial law, specifically negotiability of securities, from Commission action to eliminate by 1976 the negotiable security as a means of settlement among brokers and dealers. S. 3876, 92d Cong., 2d Sess. § 17A(o) (1972). Consider also that some definitions contained in the recent ALI proposed code differ from those contained in Article 8. *See, e.g.*, ALI FED. SECURITIES CODE §§ 216A (commercial paper), 283, 293(a), (b) and (f) (purchase does not include requisition by gift) (Tent. Draft No. 1, 1972).

that attempts to employ the private placement exemption absent use of the three transfer restriction devices is most dangerous. Beyond this point, some additional observations are in order. While the mandatory language of Proposed Rule 146 concerning use of the three devices will promote acceptance of such use, the absolute distribution test of § 146(f) (and in the analogous context of intrastate offerings, the absolute standard of Proposed Rule 147(e) limitations) will guarantee continuing interest in the protection afforded by Article 8. A right of first refusal both as providing a basis for adverse claim and as putting the issuer on notice of impending secondary distribution is worthy of consideration. Whatever the restrictions, these, along with the letter of investment intent and the legend, should be negotiated early in the process of the placement and should be included verbatim in attendant agreements. It is suggested, moreover, that the letter of intent recite the offeree's knowledge of the restrictions of Rule 144. Finally, it is suggested that careful client education by the attorney will help to convince both issuer and offeree of the necessity for the restrictions. Perhaps these restrictions will appear less formidable if the agreement and legend change the opining attorney to one suitable to the offeree after a holding period of two years, for example.

In any event, it does appear that the protection to be afforded the private placement issuer by Article 8 is not so solidified as may have been assumed.

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